Capital

The Bottomless Pit Of Fannie And Freddie

Thomas F. Cooley, 06.23.10, 10:45 AM ET

A nasty exchange broke out last week in the House-Senate conference committee that is finalizing financial regulatory reforms. Some Republican members of the group began castigating the architects of financial reform for not having dealt with the big problem of Fannie Mae and Freddie Mac, which continue to require taxpayer bailouts to the tune of hundreds of billions of dollars. Barney Frank and Christopher Dodd rightfully brought the focus back to the matters at hand, the Restoring American Financial Stability Act. The Republicans may have engaged in disruptive behavior, but they have an important point. Financial stability is not likely to be restored until we figure out what to do about mortgage finance.

It is quite amazing that the financial reform legislation didn't take on the problem of Fannie Mae and Freddie Mac, but it may be because it will turn out to be the thorniest and most divisive issue on the reform agenda. Thinking seriously about housing markets and housing finance requires nothing less than rethinking the American Dream. By that I mean the dream that every American household should strive to own their home. Public policies enacted to foster the pursuit of that dream have created huge distortions in our economy that will be very costly to undo. They have also--through the malfeasance of Fannie and Freddie (encouraged by the likes of Barney Frank)--created an enormous liability for U.S. taxpayers.

The GSEs (Fannie and Freddie) functioned as quasi-private companies that bought, bundled and securitized trillions of dollars of mortgages, in the form of mortgage-backed securities. Because investors in these MBS might otherwise be nervous about whether the mortgage borrowers will actually repay their mortgages, the GSEs have guaranteed the credit (default) risk on these MBS, in return for a small fee.

Fannie and Freddie hold or guarantee more than $5 trillion worth of mortgages. That is approximately one-third of U.S. GDP. Because of their federal backing, Fannie Mae and Freddie Mac provide capital and guarantees to the mortgage market at lower prices than private financial institutions can offer, which ultimately transfers risk from the two entities to taxpayers. To date it has cost us close to $150 billion and conservative estimates by the Congressional Budget Office as of last January were that it will cost roughly $389 billion. Less conservative estimates have put the cost as high as $1 trillion. That is a very expensive dream.

A darker side of this story is that our reliance on funding this dream by selling these U.S. government guaranteed mortgage securities abroad has distorted our ability to deal with the insolvency of the GSEs and subjected us to blackmail by foreign holders of these liabilities. Last week economists at the Council on Foreign Relations highlighted an important episode illustrating the danger. In his recently published memoir former Treasury Secretary Henry Paulsen mentioned that in mid 2008 Russian officials approached the Chinese government and suggested that both dump the securities of the GSEs to put pressure on the U.S. to fully back them. The Chinese apparently demurred but, according to the CFR, they still sold nearly $50 billion during 2008 while the Russians liquidated their entire holdings of over $170 billion. This episode put enormous pressure on Fannie and Freddie, increasing the spread between Treasuries and GSE debt enormously and practically killing the repo market. In the end the U.S. was forced to put them into conservatorship.

This episode illustrates one of the great dangers of relying on foreign sources to fund our American obsession with owner-occupied homes. Not only did it expose us to economic blackmail, it made it more difficult for us to think about resolving the bankrupt institutions in a rational way. As an interim measure we essentially nationalized them--the U.S. stake is about 80% or more. We do not, however, include them on the government's balance sheet or in the budget, and we don't treat their liabilities as government debt. But U.S. taxpayers are still on the hook.

There is no way to extract ourselves from this mess without first questioning the American Dream and second asking what is the appropriate role of government in the housing sector. There are some positive aspects to the American Dream. Advocates argue that owner-occupied housing has positive externalities for society. These include better neighborhoods and communities because homeowners take more pride in them and they build more social capital. All of this, it is argued, promotes social stability.

And of course there is the enormous tax subsidy to homeownership that comes from the deductibility of interest payments on up to $1 million of mortgage. But think about the incentives this creates. It motivates households to increase their leverage and to consume more housing. The average American house size has more than doubled since the 1950s; it now stands at 2,349 square feet. The move toward ever larger homes has been accelerating for years. Perhaps we have to question whether, as a country, this is where we want our capital invested.

What role should the government play in the future? Many countries have high levels of homeownership without the government playing such an important role and without the tax distortions that our system provides. One option would be to consolidate the portfolios of the GSE's into a single entity and liquidate them gradually. Then we should privatize the securitization of mortgages and take the government out of the business. If the private sector can't function without government guarantees then these should be made explicit and should be priced.

There is no question that this is a tall order and that the resolution process could take a few years. Unfortunately, delaying only makes the problem worse and only subjects us to more blackmail and pressure from the foreign holders of our semi-sovereign debt. Ignoring this problem, as the administration has done so far, simply keeps the bailout spigot open.

Thomas F. Cooley is the Paganelli-Bull professor of economics and emeritus dean of the NYU Stern School of Business. He writes a weekly column for Forbes. He is a co-editor of the forthcoming book Regulating Wall Street: The New Architecture of Global Finance *(Wiley, 2010).*